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03-932

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

DURA PHARMACEUTICALS, INC. ET AL.,

Petitioners,

—v.—

MICHAEL BROUDO ET AL.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF OF CITY OF NEW YORK PENSION FUNDS, THE CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM, THE CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM, LOS ANGELES COUNTY EMPLOYEES RETIREMENT ASSOCIATION AND ALAN G. HEVESI, COMPTROLLER OF THE STATE OF NEW YORK, AS TRUSTEE OF THE NEW YORK STATE COMMON RETIREMENT FUND AND AS ADMINISTRATIVE HEAD OF THE NEW YORK STATE AND LOCAL RETIREMENT SYSTEMS AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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INTEREST OF THE *AMICI CURIAE*

This *amicus* brief is filed on behalf of the pension funds of the City of New York ("NYC Pension Funds"), the California Public Employees' Retirement System ("CalPERS"), the California State Teachers' Retirement System ("CalSTRS"), Los Angeles County Employees Retirement Association ("LACERA") and Alan G. Hevesi, Comptroller of the State of New York, as Trustee of the New York State Common Retirement Fund and as Administrative Head of the New York State and Local Retirement Systems ("NYSCRF") (collectively, the "Public Pension Funds" or "Funds"). The Public Pension Funds are comprised of four of the five largest public pension systems in the United States.

The NYC Pension Funds comprise the actuarial pension systems of New York City and are among the largest public pension systems in the United States.[1] The NYC Pension Funds include the New York City Employees' Retirement System, the Police Pension Fund, the Fire Department Pension Fund, the Teachers' Retirement System, the Board of Education Retirement System, and five variable supplement funds.[2] As of June 30, 2003, the

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[1] Pursuant to Supreme Court Rule 37.4, *amicus* the NYC Pension Funds states that they are instrumentalities of the City of New York, and this brief is being presented by Leonard J. Koerner, Chief Assistant Corporation Counsel, Corporation Counsel of the City of New York. In addition, *amici* state that no counsel for any party authored this brief in whole or part, and no person or entity other than the *amici* made a monetary contribution to the preparation or submission of the brief. Pursuant to Rule 37.3, *amici* state that petitioners and respondents have consented to the filing of this brief. Petitioners' and respondents' letters of consent have been filed with the Clerk of the Court.

[2] The variable supplement funds are: New York City Police Superior Officers' Variable Supplements Fund, New York City Police Officers' Variable Supplements Fund, New York City Fire Officers'

date of the most recent actuarial valuations for these Funds, the NYC Pension Funds had approximately 253,000 retired members, 340,000 active members, and aggregate assets of $73.971 billion.

CalPERS, the largest public pension fund in the United States, manages pension and health benefits for more than 1.4 million California public employees, retirees, and their families. CalPERS' membership is divided approximately in thirds among current and retired employees of the state, schools, and participating public agencies. As of September 30, 2004, CalPERS provided benefits for 1,014,360 active and inactive members and 413,272 retirees. As of August 31, 2004, CalPERS has $165.3 billion in total investments, of which nearly $110 billion is in equities.

CalSTRS is the largest teachers' retirement system in the United States. CalSTRS' primary responsibility is to provide retirement related benefits and services to teachers in public schools from kindergarten through community college. As of June 30, 2003, CalSTRS had a total membership of approximately 734,963 (553,095 active/inactive and 181,868 retired/benefit recipients) and, as of June 30, 2004, had total assets of $116.1 billion.

LACERA is the largest county retirement system in the United States. LACERA provides retirement, disability, and death benefits to eligible Los Angeles County employees and their beneficiaries. As of June 30, 2004, LACERA had a total membership of approximately 140,000 and total assets of nearly $30 billion.

NYSCRF is the second largest public pension fund in the United States. NYSCRF provides pension, death and

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Variable Supplements Fund, New York City Firefighters' Variable Supplements Fund, and New York City Teachers' Retirement System Variable Annuity A and B Programs.

disability benefits for New York state and local government employees and employees of certain other participating employers. As of March 31, 2004, NYSCRF had over 970,000 members, beneficiaries and retirees, and total net assets of approximately $120.8 billion.

The Public Pension Funds' overriding responsibility is to provide for the retirement and long-term security of their more than 3.8 million active and retired members. To satisfy that responsibility, the Public Pension Funds invest in a wide variety of stocks, bonds and other assets, through a variety of advisors, in order to maintain the long-term growth and security of their members' assets. As major investors with a long-term investment outlook, the Public Pension Funds are vitally concerned with the proper and efficient functioning of U.S. capital markets, and are particularly concerned that investors not be harmed by the improper and/or illegal conduct of issuers and sellers of publicly traded securities.

Over the last five years, the Public Pension Funds have become increasingly concerned that the pressure for short-term profit maximization at a number of enormous and well-respected U.S. (and foreign) corporations has created an environment in which management, their advisors (including outside advisors such as accountants and lawyers), and others involved in the purchase and sale of their securities (stock brokerage firms, investment banking firms, *etc.*) are willing to engage in unethical, illegal and improper behavior to manipulate stock prices for their personal or institutional benefit. The scandals at Enron, WorldCom, Global Crossing, Tyco, Bristol-Myers, Xerox and others are now synonymous with the culture of greed that has tarnished all U.S. corporations and caused hundreds of billions, if not trillions of dollars in losses to innocent investors. The Public Pension Funds have lost billions of dollars in invest-

ments where the prices were inflated through accounting fraud, market manipulation and other means.

The Public Pension Funds recognize that the oversight of regulators such as the U.S. Securities and Exchange Commission and the New York Attorney General's Office is an important means of ensuring a level playing field for all investors. The Funds strongly believe, however, that the ability of investors to seek to redress corporate wrongdoing through class and individual actions brought under the Securities Act of 1933 ("1933 Act"), 15 U.S.C. § 77a *et seq.* and the Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. § 78a *et seq.*, is an important mechanism to deter improper conduct and to recoup losses that investors have suffered as a result of fraud and other misconduct. Thus, the Public Pension Funds have acted as lead plaintiffs in several significant cases, including *In re Cendant Corporation Securities Litigation*, (D.N.J.) (NYC Pension Funds, NYSCRF and CalPERS were co-lead plaintiffs), where the $3.2 billion settlement remains the largest recovery in the history of securities litigation. In addition, NYSCRF as lead plaintiff in the *In re WorldCom, Inc. Securities Litigation* (S.D.N.Y.) has secured District Court approval of the second largest settlement in history, nearly $2.6 billion from Citigroup defendants, Citigroup, Inc., Citigroup Global Markets, Inc. (formerly known as Salomon Smith Barney, Inc.), Salomon Brothers International Limited, and former securities analyst Jack Grubman. LACERA has served as lead plaintiff in the *Enterasys Networks, Inc. Securities Litigation* (D.N.H), and the *King Pharmaceuticals Securities Litigation* (E.D.TN), and CalSTRS is serving as lead plaintiff in *In re Homestore Securities Litigation* (C.D. Cal.). Certain of the Public Pension Funds also have brought individual actions against Bristol-Myers Squibb, Inc., Qwest Communications, Inc., and others.

A key element of the legal regime governing the initiation, prosecution and resolution of claims under Section 10(b) of the 1934 Act, and Rule 10b-5 promulgated thereunder, is the issue of loss causation. While the Public Pension Funds recognize that the federal securities laws are not a form of "insurance" to protect investors against market-based declines in the price of securities and that companies should not be liable for declines in their stock prices that do not result from their fraudulent conduct, as investors who have been materially harmed by entities that have resorted to fraudulent and improper conduct, the Funds are vitally concerned that the legal regime governing securities fraud litigation allows investors who have been harmed to recover from those entities that have engaged in fraud. At the same time, as significant investors in thousands of corporations and business entities that never have been touched with so much as a taint of fraud, the Public Pension Funds have a strong interest in ensuring that the rules governing securities litigation do not unfairly harm companies that have not engaged in wrong-doing. Because a failure by a plaintiff to plead and ultimately prove loss causation will impair that plaintiff's ability to recover for fraudulent conduct, the Public Pension Funds are submitting this brief as *amici curiae* to assist this Court in developing rules that adequately protect honest companies and their investors, while permitting valid claims against those companies that have engaged in fraudulent conduct.

SUMMARY OF ARGUMENT

The Public Pension Funds support the Respondent and believe that the decision of the Ninth Circuit in *Broudo v. Dura Pharmaceuticals, Inc.*, 339 F.3d 933 (9th Cir. 2003), *cert. granted, Dura Pharmaceuticals, Inc. v. Broudo*,

124 S. Ct. 2904 (U.S. June 28, 2004) (No. 03-932), which does nothing more than follow a notice pleading standard for loss causation under Rule 8 of the Federal Rules, should be affirmed. At the pleading stage, under the liberal pleading requirements of Rule 8 of the Federal Rules of Civil Procedure, a plaintiff should be required merely to allege a "short and plain statement" that (i) the stock price was inflated by fraud and (ii) the inflation, at least in part, has been removed. At the pleading stage, a plaintiff should not be required to demonstrate the negative impact on the share price of each piece of information that may have revealed some aspect of the defendants' fraud. A plaintiff ultimately should be required to demonstrate that he or she overpaid for a security as a result of the dissemination of fraudulent information about the company, and that the price of the stock no longer is inflated due to fraud. There should be no requirement, however, that a defendant have made an explicit disclosure that fraud has occurred nor should there be any requirement that there be a stock price drop immediately following a specific admission of fraud in order to state a claim as a matter of law.

The issue of loss causation, as it has evolved over the last thirty years, is codified in the Private Securities Law Reform Act of 1995 ("PSLRA"), 15 U.S.C. § 78u-4, and is essentially a requirement that a plaintiff establish "that the act or omission of the defendant alleged to violate [the 1934 Act] caused the loss for which the plaintiff seeks to recover damages." *Id.* at § 78u-4(b)(4). In most securities fraud cases, the "loss" at issue is related to a decline in the value of a stock or bond caused by the disclosure of prior fraudulent statements by the issuer of the security, the issuer's agent (usually an accountant) or a third party that has an interest in manipulating the price of the security. Thus, the proper goal of any test

for loss causation is to determine the legal responsibility for changes in the price of stocks, bonds and/or other securities that were impacted by materially false statements.

The entire discipline of corporate finance, a mainstay of U.S. business schools over the last two to three decades, has, as one of its primary goals, the development of models to determine the true economic value of business entities. The principles of corporate finance, while greatly utilized in the business world to determine the value of corporations and securities that reflect ownership in corporations, as well the basis for changes in valuations, are much less frequently used by courts in making legal determinations regarding changes in the value of securities. Because a key issue in lawsuits brought under the federal securities laws is the cause of the decline in the value of securities, *i.e.*, loss causation, an issue that is subject to these well-understood principles of corporate finance, the Public Pension Funds respectfully urge that any legal determination as to what caused the decline in the value of the security should generally be premised upon such corporate finance principles.

The present case represents this Court's first opportunity to address directly the legal principles that will govern the pleading and proof of loss causation in securities fraud litigation. In conducting its analysis, the Court should be fully aware of, and should reach a decision consistent with, principles of corporate finance, which generally equate the value of a corporation with investors' expectations of the "cash flows" that they ultimately will receive from that corporation.[3] Under sound

[3] A method other than cash flow expectations may need to be used to value corporations in some circumstances. *See M.G. Bancorporation, Inc. v. LeBeau*, 737 A.2d 513, 524 (Del. 1999) ("by recognizing the discounted cash flow model as one proper valuation technique, the

principles of corporate finance, where expectations of future cash flow have been artificially inflated because of fraud, the resulting stock price also is artificially inflated by fraud. Thus, as explained in detail below, the Public Pension Funds propose that this Court adopt a test for loss causation, based on fundamental principles of corporate finance, that poses the following questions: (1) did a defendant make a materially misleading statement to the investing public that inflated the stock price of a company, and (2) as the result of disclosures of information by the company or others, is the stock price no longer inflated because the fraud is no longer propping-up the price? Where these questions are answered in the affirmative, loss causation is established.

Any requirement, such as that implicit in Petitioner's opening brief (Pet'r Br. at 21-22, 37), or as explicitly set forth in the briefs of certain *amicus curiae* (Brief of Chamber of Commerce of the United States as *Amicus Curiae* in Support of Petitioners ("CC Br.") at 13-14), that there must be an explicit disclosure of fraud followed by a stock price drop, would be inconsistent with the law and basic corporate finance principles, and would allow many frauds to fall outside the ambit of the securities laws.

Finally, while a plaintiff ultimately should be required, with the benefit of discovery and expert analysis, to establish that the price of a stock was no longer inflated due to fraud, no such strict linkage should be required at the pleading stage. Plaintiffs are required to plead fraud with particularity and to plead facts supporting a strong inference of defendants' scienter. Thus, any case that survives a motion to dismiss, even using the Ninth Circuit standard on loss causation for pleading purposes (or a similar standard), will have adequately pled the existence of fraudulent statements that inflated the price of the security at issue and strong support that such statements were knowingly or recklessly made. Where these facts can be pled, it is not unduly onerous on defendants if Plaintiffs are permitted to prosecute their action.

Court of Chancery was not required to use that methodology. . . ."). However, using corporate finance principles will allow this Court to establish an appropriate standard for loss causation.

On the other hand, establishing a strict loss causation requirement at the pleading stage is inconsistent with federal pleading standards and will place unfair burdens on securities plaintiffs. Any requirement that securities plaintiffs be required to plead, other than in general terms, a linkage between changes in the price of a stock and specific disclosures could require a detailed expert opinion demonstrating that revelation of the fraud had an impact on the price of the securities at issue. Requiring such an expert report at the pleading stage would effectively preclude meritorious actions because of the enormous expense of such reports (*see infra* Section I.A) and the need (in many cases) for some discovery to produce a rigorous report. Thus, the Court should affirm the decision of the Ninth Circuit for pleading purposes.

ARGUMENT

I. THE COURT SHOULD ADOPT A FLEXIBLE STANDARD FOR PROVING LOSS CAUSATION AND SHOULD NOT ADOPT A STANDARD THAT WOULD REQUIRE PLAINTIFFS TO SHOW A DECLINE IN THE PRICE OF A SECURITY AFTER THE EXPLICIT DISCLOSURE THAT FRAUD HAS OCCURRED

The Court below in *Broudo v. Dura Pharmaceuticals, Inc.*, addressed a situation in which a defendant revealed truthful information that corrected earlier, allegedly

fraudulent information, but the stock drop complained of had occurred ten months prior to the truthful disclosure. It held that:

> "it is not necessary that a disclosure and subsequent drop in the market price of the stock have actually occurred, *because the injury occurs at the time of the transaction . . . . [L]oss causation does not require pleading a stock price drop following a corrective disclosure or otherwise.* It merely requires pleading that the price at the time of purchase was overstated and sufficient identification of cause."

339 F.3d at 938. In opposing the loss causation standard adopted by the Ninth Circuit, Petitioner suggests (and certain *amici* specifically argue) that loss causation should only be established where there is a price decline following the explicit disclosure of fraud. (Pet'r Br. at 21-22, 37; CC Br. at 13-14) Certain courts and commentators have propounded such a rule and concluded that a stock drop following the explicit disclosure of fraudulent activity is essential to establish loss causation and, hence, is a *sine qua non* for a plaintiff to prevail on the merits and ultimately recover damages. *See, e.g., Arduini/Messina P'ship v. Nat'l Med. Fin. Servs. Corp.*, 74 F. Supp. 2d 352, 361–62 (S.D.N.Y. 1999); *Anderson v. First Sec. Corp.*, 249 F. Supp. 2d 1256, 1268 (D. Utah 2002); *In re Sprint Corp. Sec. Litig.*, 232 F. Supp. 2d 1193, 1228 (D. Kan. 2002).[4]

An inflexible rule such as that proposed by Petitioners, some *amici* and certain commentators has the potential to create serious problems since it would effectively eliminate a large number of meritorious actions at the

[4] *See also* Brian E. Pastuszenski et al., *Beyond Materiality and Scienter: Strategies For Successfully Defending Securities Class Actions By Attacking Plaintiffs' Loss Causation and Damages Theories*, ALI-ABA Securities Litigation Planning and Strategies 572–73 (2001).

pleading stage in order to address a very small subset of securities cases. Three examples will illustrate the problem. The classic securities fraud case, where the stock price collapses upon disclosure of fraud, typically does not present a difficult loss causation issue. Assume that the stock of Company A (with 100 million shares) is priced at $10 per share at the beginning of a period and, thereafter, Company A makes false statements that its revenues were $1 billion last year and its profits were $250 million. Based upon those favorable reports, investors believe the Company will earn $300 million or $3 per share going forward. As a result, the price of the stock increases to $30 per share. Six months later, the Company admits that its $1 billion in revenue and $250 million in profits were false because of the booking of fictitious sales and that the correct numbers were $750 million in revenues and a $200 million loss. Investors immediately understand that the Company will not be earning $300 million ($3 per share) going forward. The stock price immediately falls to $10 per share as investors determine that the Company will probably just break-even over the next year. In this case, under any theory, there clearly is loss causation since the announcement of the true information causes an immediate and substantial decline in the cash flow expectations and share price.

The more difficult situation however, and one that is common in financial fraud securities cases, is where Company A does not explicitly label corrective information as related to a fraud. Assume, as above, that Company A releases false information that its revenues were $1 billion and its profits were $250 million. As a result, investors believe the Company will earn $300 million going forward, or $3 per share. However, the actual undisclosed numbers were $750 million in revenues and a $200 million loss. Over the next six months the stock price increases to $30 per share. At the end of

the six months, the Company realizes it has a problem and will not be able to keep booking the fictitious sales. Rather than disclose the truth about its past practices, over the next few months, the Company gradually discloses that it will only break-even over the next year. The stock price declines to $10 based upon those deflated expectations. Investors do not know that the deflation in the expectations is the result of a fraud. Only after the price has declined to $10 does the Company admit that its older financial information ($1 billion in revenue and $250 million in profits) was false, that its true information for that year was $750 million in revenue and a $200 million loss, and that its more recent information is accurate. After this announcement, however, the share price does not decline further because the market has already incorporated the decline in expectations resulting from the cessation of the fraud in the Company's stock price.

Under such circumstances, the Petitioner would take the position, as would some of the *amicus* briefs, decisions and commentators referenced above, that there is no loss causation because the share price did not decline after the disclosure of the existence of the fraud. Yet investors in this scenario purchased a stock at an inflated price due to fraud and lost money when the stock price declined because truthful information was revealed about the company's actual performance and the fraud no longer propped-up the price. The only difference between the second scenario and the first scenario is the manner in which the fraud is disclosed. In the second scenario the company manipulated the disclosure, cleverly revealing the truth without labeling it fraud.

The third scenario, which essentially is the one upon which the Petitioner focuses, is where Company A releases the same false information described above ($1 billion in

revenue, $250 million in profits) causing investors to believe there will be $300 million in earnings and thus the price increases to $30 per share. Thereafter, as the result of some event wholly unrelated to the fraud (market-shift, earthquake, fire, *etc.*), Company A becomes essentially worthless. Thereafter, the fraud is disclosed and a suit is brought for securities fraud. In such a case, the plaintiff will be unable to prove that the fraud caused the loss. Therefore, loss causation is absent.

The Public Pension Funds believe that an appropriate standard of loss causation is one that does not eliminate the meritorious cases that fall under example two above, merely to ensure that the cases that conform to example three do not result in the imposition of damages. Thus, while the Public Pension Funds agree that, at trial, loss causation requires some showing that the price of a stock no longer was inflated as the result of the disclosure of information correcting earlier fraudulent information, the Court should not adopt a standard that requires a plaintiff to prove the existence of a stock drop following the explicit disclosure of fraud. Such a standard would be inconsistent with the origins and development of the loss causation doctrine and contrary to applicable principles of corporate finance. Instead, this court should adopt a flexible standard under which the issues are whether the stock price was inflated by fraud and whether that inflation no longer is present because the fraud no longer is impacting the price. If a plaintiff can establish the existence of these two conditions, loss causation should be established.[5]

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[5] *See* Jay Eisenhofer, Geoffrey Jarvis & James Banko, *Securities Fraud, Stock Price Valuation And Loss Causation: Toward A Corporate Finance-Based Theory Of Loss Causation*, 59 Bus. Law. 1419, 1441-45 (2004) (setting forth in detail a theory of loss causation based upon corporate finance principles).

A. Proof Of Loss Causation Is Inherent In Any Proof Of Damages

Proving loss causation often is inextricably linked to the analysis of damages, since both inquiries seek to determine the links between a defendant's fraudulent conduct and the consequent losses suffered by plaintiffs from a decline in the price of a security. Many early securities cases simply fixed the damages as the difference between the price paid for the securities and the value of the securities determined as of the time of the discovery of the fraud. *See Esplin v. Hirschi*, 402 F.2d 94, 104–05 (10th Cir. 1968), *cert. denied*, 394 U.S. 928 (1969) (court held the defrauded buyer is entitled to recover the difference between the price paid for the securities and the value of the securities determined as of the time of the discovery of the fraud); *Harris v. American Inv. Co.*, 523 F.2d 220, 226–27 (8th Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976) (appropriate date for ascertaining damages sustained to stockholder as result of violation of securities laws prohibiting publishing of false and misleading statements and filing of false and misleading information was the date of public discovery of fraud). This methodology was simple enough, but met with opposition from defendants and commentators because it ignored factors impacting stock price, such as overall economic and industry factors, that were unrelated to any possible fraud. *See, e.g.*, Barry Reder, *Measuring Buyers' Damages in 10b-5 Cases*, 31 Bus. Law. 1839, 1846–50 (1976).

In 1976, Judge Sneed of the United States Court of Appeals for the Ninth Circuit, in a sconcurring opinion in *Green v. Occidental Petroleum Corp.* set forth a theory for measuring damages that proved to be a milestone. Judge Sneed postulated that in a securities fraud class action, the best way to measure the loss proxi-

mately caused by the misrepresentation of a defendant is to create a chart containing a "price line" and a "value line." 541 F.2d 1335, 1341, 1344 (9th Cir. 1976) (Sneed, J. concurring). Pursuant to Judge Sneed's method, damages are calculated by subtracting the true value of the stock on the date of purchase from the price actually paid, with the spread between the price and value lines varying over time. *See* Bradford Cornell & R. Gregory Morgan, *Using Finance Theory to Measure Damages in Fraud on the Market Cases*, 37 UCLA L. Rev. 883, 887 fig. 1 (1990).

As courts began to adopt Judge Sneed's "value line" concept, an issue arose as to the best methodology for determining a stock's "true value," *i.e.*, value absent the fraud. A methodology that began gaining some measure of acceptance was the use of an "event study" to determine true value. *See, e.g., Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1437 (9th Cir. 1987) (recognizing the significance of fraud-related and non-fraud related influences on the stock's price behavior and stating "the increment of artificial inflation caused by misrepresentations may fluctuate 'as a result of market forces operating on the misrepresentations.' "); *In re Oracle Sec. Litig.*, 829 F. Supp. 1176, 1181 (N.D. Cal. 1993) (requiring use of an event study or similar analysis to more accurately isolate the influences of information specific to the Company which defendants allegedly distorted).

An event study is a statistical regression analysis that examines the effect of an event on a dependent variable, such as a corporation's stock price. *RMED Int'l, Inc. v. Sloan's Supermarkets, Inc.*, No. 94-5587, 2000 WL 310352, at *6 (S.D.N.Y. Mar. 24, 2000) (citing Jon Koslow, *Estimating Aggregate Damages in Class-Action Litigation Under Rule 10b-5 for Purposes of Settlement*, 59 Fordham L. Rev. 811, 822 & n.50 (1991)). This approach assumes that the price and value of the security

move together except during days when disclosures of company-specific information influence the price of the stock. The analyst then looks at the days when the stock moves differently than would be anticipated based upon market and industry factors—so-called days of "abnormal returns." The analyst then determines whether those abnormal returns are due to fraud or non-fraud related factors. *See* Cornell & Morgan, 37 UCLA L. Rev. at 899–900. This effectively is a determination of loss causation since it establishes the link between the fraud and the loss.

Over time, the majority of courts have recognized the utility of the event study methodology in the securities context and have begun to require experts to include event studies with their damages reports in order "to distinguish between the fraud-related and non-fraud related influences on the stock's price behavior." *Oracle*, 829 F. Supp. at 1181. Courts have held that the event study method is "an accepted method for the evaluation of materiality damages to a class of stockholders in a defendant corporation." *In re Gaming Lottery Sec. Litig.*, 96-5567, 2000 WL 193125, at *1 (S.D.N.Y. Feb. 16, 2000) (citing Eugene Fama et al., *The Adjustment of Stock Prices to New Information*, 10 Int'l Econ. Rev. 1 (1969)); David Tabak & Frederick Dunbar, *Materiality and Magnitude: Event Studies in the Courtroom*, NERA Working Paper No. 34 (April 1999). Indeed, a number of courts have rejected or refused to admit into evidence damages reports or testimony by damages experts in securities cases that fail to include event studies or some similar analysis.[6] *See In re Northern Telecom Sec. Litig.*,

[6] A method other than an event study may be used to determine damages in a particular case. *U.S. v. Brown*, 2004 WL 2242513 (M.D.Pa. Aug 17, 2004) (applying methodology other than event study in determining loss).

116 F. Supp. 2d 446, 460, 468 (S.D.N.Y. 2000) (court granted defendants' motion for summary judgment where the defendants' expert had conducted an event study concluding that none of the allegedly fraudulent statements resulted in inflation of defendant's stock price and plaintiffs' expert did not conduct such a study); *Oracle Sec. Litig.*, 829 F. Supp. at 1181 (court found that the "[u]se of an event study or similar analysis is necessary more accurately to isolate the influences of information specific to Oracle. . ."). *See also In re Executive Telecard, Ltd. Sec. Litig.*, 979 F. Supp. 1021 (S.D.N.Y. 1997) (requiring an event study in a 10b-5 damages case and setting forth standards for such a study).

As a result of cases such as *Executive Telecard*, defendants have created an environment in which plaintiffs' damages analyses are required, in most cases, to comply with basic principles of corporate finance and include as damages only those factors that are related to the fraud. *See, e.g., In re WorldCom, Inc. Sec. Litig.*, No. 02-3288, 2003 WL 22420467, at *28 n.42 (S.D.N.Y. Oct. 24, 2003). Thus, an event study, a complex analysis often comprising thousands of pages of analysis prepared by an expert, is used to exclude factors from the overall economy (such as an overall stock market price decline), factors impacting the relevant industry, and factors related to the specific company that are not fraud related. Because of the detailed nature of these analyses, they require that the expert have access to substantial information regarding the fraud (often from discovery), take many months to prepare, and frequently cost many hundreds of thousands of dollars. Accordingly, as explained below, the Court, in determining the appropriate pleading standard (as opposed to ultimate requirements of proof at trial), should not establish a pleading standard that would effectively require plaintiffs to con-

duct event studies prior to the initiation of litigation. *See infra* Section II.

B. A Flexible Loss Causation Standard Is Consistent With Principles Of Corporate Finance

Under well-accepted theories of corporate value, a stock will be worth to investors what they ultimately can obtain from it—dividends or an increase in value through retained earnings. Richard Brealey & Stewart Myers, *Capital Investment and Valuation* 77 (McGraw Hill 2003). The best measure of what value a company ultimately will provide to investors is the discounted value of future cash flows, *i.e.*, discounted value of the cash that comes in less the cash that goes out over time. Thus, corporate finance theory holds that the stock price of a company reflects the market's estimation of the company's future cash flows into infinity, discounted to reflect the fact that money received in the future is less valuable then money received today. Such "discounting" is carried out through a "rate" that is equivalent to the company's cost of capital. *Id.* ("The value of a stock is equal to the stream of cash payments discounted at the rate of return that investors expect to receive on comparable securities").[7] This approach to valuation is broadly agreed upon by financial economists and is the

[7] *See also* Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 Mich. L. Rev. 613, 616 n.11 (1988) ("Efficient market prices which reflect all available information relevant to the value of the stock are thought to measure rationally the 'worth' of stocks as financial instruments in terms of the present value of their expected future earnings, discounted for nondiversifiable risk."); Burton Malkiel, *Is the Stock Market Efficient?* 243 Science 1313, 1316 (1989) (describing the standard "rational" model of share pricing as one of determining the present discounted value of the future stream of dividends).

basis for substantial portions of modern corporate finance theory. *Id.*

Discounted cash flow ("DCF") analysis is typically used to determine the value of a company by calculating the present value of its future cash flows. The DCF analysis is premised on the assumption that the value of all of a corporation's assets is equal to the present value of the expected cash flow from those assets while they are held by the corporation. *Id.* at 52-54 ("the discounted-cash-flow (DCF) formula for the present value of a stock is just the same as it is for the present value of any other asset. We just discount the cash flows by the return in the capital market on securities of comparable risk."); *Neal v. Alabama By-Products Corp.*, No. 8282, 1990 WL 109243, at * 7 (Del. Ch. Aug. 1, 1990), *aff'd*, 588 A.2d 255 (Del. 1991) (noting that DCF analysis is considered by valuation experts to be a "preeminent valuation methodology") (citing Shannon Pratt, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies* (2d ed. 1989)).

The basic principle outlined above—that stock prices are a reflection of future cash flows—has received judicial acceptance by numerous courts in valuation and bankruptcy settings. *See Onti, Inc. v. Integra Bank*, 751 A.2d 904, 916 (Del. Ch. 1999) (in action for declaratory judgment on fairness of cash-out merger court stated "this Court has frequently employed the discounted cash flow as at least one method of valuation"); *Neal*, 1990 WL 109243, at * 7 (noting that DCF analysis is considered by valuation experts to be "preeminent valuation methodology"); *see also In re Valley-Vulcan Mold Co.*, No. 99-4129, 2001 WL 224066 (6th Cir. Feb. 26, 2001) (noting, with approval, that expert's "valuations were based on discounted cash-flow valuation, a well-recognized methodology for determining a business's going

concern values."); *In the Matter of Genesis Health Ventures, Inc.*, 266 B.R. 591, 613 (Bankr. D. Del. 2001) (noting the use of the discounted cash flow method as one method to support value of an enterprise).

Those principles have not, however, been widely employed in securities litigation, even though this information is relevant to the company's stock price as an indicator of the company's *future* cash flows. This is a mistake since these concepts have great relevance in that area. When a company publicly discloses its *present* or *past* financial performance, this information is relevant to the company's stock price as an indicator of the company's *future* cash flows.[8] Thus, looking at cash flows and at the information, whether correct or incorrect, that

[8] William Beaver, *Financial Reporting: An Accounting Revolution* 69 (Prentice-Hall 3d ed. 1998) ("A conceptual relationship can be established between accounting earnings and the price of common stock by introducing three critical links: (1) a link between security price and future dividends, (2) a link between future dividends and future earnings, and (3) a link between future earnings and current earnings"); Tom Copeland, Tim Koller & Jack Murrin, *Valuation: Measuring and Managing the Value of Companies* 154 (John Wiley & Sons 3d ed. 2000) ("[t]he first step in valuing a business is analyzing its historical performance. A sound understanding of the company's past performance provides an essential perspective for developing and evaluating forecasts of future performance"); George Foster, *Financial Statement Analysis* 220-24 (Prentice-Hall 2d ed. 1986) ("[t]he accounting literature contains many statements about what information is (or should be) impounded into security prices . . . . *A common assumption is that there is a mechanistic relation between reported accounting earnings and stock prices*") (emphasis in original); *see also* Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus. Law. 1 (1982) (discussing use of current and historical data in determining cash flows for valuation); Jonathan Fuerbringer, *Yesterday's Earnings Don't Move Stocks. Tomorrow's Do*, N.Y. Times, Aug. 8, 2004, at 7 (citing analysis by Birinyi Associates demonstrating that expected future earnings, not past earnings, are the driver of stock prices).

impacts such flows, can be of substantial value to courts attempting to ascertain whether particular information provided to the public by defendants has actually impacted the price of a stock at issue in a particular case.

C. An Appropriate Standard for Pleading and Proving Loss Causation Should be Based Upon Sound Principles of Corporate Finance

From the origins of the doctrine, courts have grappled with the appropriate test for determining whether a specific set of facts establishes loss causation. Courts want a standard that requires the defendant's fraud to have caused the plaintiff's loss, but are struggling in those increasingly frequent cases where there is not a disclosure of fraudulent conduct followed immediately by a material decline in the price of the company's stock.

As shown above, some courts have effectively refused to consider the issue at all, finding that there can be no loss causation if a stock decline does not immediately follow a disclosure of fraud. *See, e.g., In re Ikon Office Solutions, Inc. Sec. Litig.*, 131 F. Supp. 2d 680, 687 (E.D. Pa. 2001). This makes no sense because there are clear cases of fraud where the stock declined substantially prior to the formal announcement of the fraud and thus there was little room for further decline after the fraud was announced. *See, e.g., Danis v. USN Communications, Inc.*, 73 F. Supp. 2d 923 (N.D. Ill. 1999); *Greenberg v. Crossroads Sys., Inc.*, 364 F.3d 657 (5th Cir. 2004).[9]

[9] It is not surprising that the stock price will decline prior to an explicit admission that fraud has occurred since most corporations are loath to admit that they have committed fraud and are strongly motivated to manipulate their disclosures to make it appear as if no fraud has occurred, even where fraud has taken place.

Other courts require that the plaintiff establish a linkage between the defendants' fraudulent statements and the decline in the value of defendants' stock, but decline to specify the nature of such a "linkage." *See Huddleston v. Herman & MacLean*, 640 F.2d 534 (5th Cir. 1981), *aff'd in part and rev'd in part*, 459 U.S. 375 (1983); *Bastian v. Petren Resources Corp.*, 892 F.2d 680 (7th Cir. 1990), *cert. denied*, 496 U.S. 906 (1990); *Robbins v. Koger Properties, Inc.*, 116 F.3d 1441 (11th Cir. 1997). A third group of courts (many in the Second Circuit) has tried to impose the "foreseeability" test used for proximate cause in tort cases, (*see Emergent Capital Investment Management, LLC, v. Stonepath Group, Inc.*, 343 F.3d 189 (2d Cir. 2003)), but that test has effectively allowed courts to reach contrary results on equivalent facts. *Compare In re Merrill Lynch & Co.*, 273 F. Supp. 2d 351 (S.D.N.Y. 2003), *with Burstyn v. Worldwide Xceed Group, Inc.*, No. 01 Civ. 1125, 2002 WL 31191741 (S.D.N.Y. Sept. 30, 2002).

Finally, some courts have only required that a plaintiff, in order to establish loss causation, demonstrate that the purchase price of a stock was inflated due to fraud, and have not imposed any requirement that the ultimate decline in the price be strictly linked to the fraud. *See No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp.*, 320 F.3d 920, 934-35 (9th Cir. 2003); *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824 (8th Cir. 2003), *reh'g denied*, 2003 U.S. App. LEXIS 17920 (8th Cir. Aug. 27, 2003); *Danis*, 73 F. Supp. 2d at 923.

In order to make loss causation a predictable and logically sound part of federal securities jurisprudence, the Public Pension Funds propose that the test for establishing loss causation should be based upon the principles of corporate finance that govern stock prices and

that have increasingly been applied in other contexts. Under basic principles of corporate finance theory, as described above, the stock price of a company reflects the market's estimation of the company's future cash flows, discounted back to the present. *See supra* Section I.B. In other words, the market price of a publicly-traded stock is based on the public's projections of how that company is going to perform in the future. *See* Thomas Lee Hazen, *The Short-Term/Long-Term Dichotomy and Investment Theory: Implications for Securities Market Regulation and for Corporate Law*, 70 N.C. L. Rev. 137, 147 (1991). Where a company publicly discloses its *present or past* financial performance, the market will use this information as an indicator of the company's *future* performance. *See supra* note 8. Thus, a disclosure (whether of current performance or anticipated future performance) that causes the market to believe that future performance will fall short of expectations, will deflate a stock price. If it is later revealed by the company or another source that the initial expectations upon which investors relied were based upon fraudulent reporting of past or present results, investors have been victimized by the fraud, even if the admission that fraud has occurred was subsequent to a stock price decline.

Accordingly, where a defendant makes a materially misleading statement to the investing public that artificially inflates the stock price of a company, and the plaintiff, in reliance on the market price of those securities as manipulated by the defendant, purchases the company's stock at such artificially inflated prices, the plaintiff should be deemed to have suffered a loss caused by the defendant to the extent of the inflation so long as the stock price no longer is being propped-up by the fraud. Thus, loss causation should be found even where the disclosures that contradict the earlier, fraudulent statements appear, when made, merely to be the report-

ing of truthful information about the company. The questions are: (i) was the stock price inflated by fraud; and (ii) has the inflation been removed?

The following hypothetical will demonstrate the application of the proposed test. Assume that ABC, Inc. has sufficient real cash flow for the present and future such that its stock should properly be valued at $50 per share. Assume further that management fraudulently reports revenues by reporting sham sales to XYZ Corp. that were not real transactions in quarters one to ten such that, based upon the discounted future value of its (artificially inflated) cash flow, the market concludes the company is worth $75 per share, even though, in reality, it is worth only $50 per share. Our plaintiff purchases stock at this point in time at $75 per share.

Finally, assume that XYZ Corp. files for bankruptcy at the end of quarter ten. From that point in time forward, ABC knows it will no longer be able to book the sham transactions. It promptly discloses that its future performance will be somewhat less than was previously expected (but not why) and, over quarters eleven to sixteen, releases revenue numbers, with attendant cash flows, that result in a company with a value of only $40 per share. At the end of quarter sixteen, ABC announces that the revenue and cash flow numbers from quarters one to ten were fraudulent, but that its current numbers are correct and, indeed, that its future numbers will be improved due to a lucrative new contract. Its stock price stays at $40 per share.[10]

Under the above facts, the plaintiff has been defrauded and, under the test we postulate, should be able to prove loss causation and recover damages for the difference

[10] Of course, it is possible in this scenario that the stock price would increase.

between the purchase price ($75 per share) and the true value ($50 per share), but not for any decline in excess of $25 per share, since any such decline would be unrelated to the fraud.

Utilizing this test for loss causation is fully consistent with the vast majority of existing loss causation jurisprudence and is also consistent with basic principles of corporate finance. So long as a plaintiff can show that the fraud resulted in expectations of improved performance, raising the stock price, and that the revelation of information related to the fraud resulted in expectations of reduced future performance, reducing the stock price, plaintiff should be deemed to have established that the fraud "caused" the loss at issue.

II. THE STANDARD OF LOSS CAUSATION PROPOUNDED BY THE NINTH CIRCUIT OR AN EQUIVALENT STANDARD IS APPROPRIATE AT THE PLEADING STAGE

In its decision in *Broudo*, the Ninth Circuit addressed a case in which a securities fraud lawsuit was brought as the result of two allegedly fraudulent statements. Petitioner Dura Pharmaceuticals, Inc. (Dura) developed and marketed products for the treatment of allergies, asthma, and other respiratory conditions. In 1995, it began developing a delivery device for asthma drugs called Albuterol Spiros. The following year, it began selling a respiratory antibiotic called Ceclor CD. In an April 15, 1997 press release announcing better-than-expected results for the first quarter of 1997, Dura stated that "strong progress" had been made in selling Ceclor CD, and that certain testing had been completed that would allow Dura to submit a new drug application ("NDA") for Albuterol Spiros to the Food and Drug Administra-

tion ("FDA"). Dura filed its application for Albuterol Spiros in November 1997.

On February 24, 1998, Dura announced that, for a number of reasons, including slower than expected sales of Ceclor CD, it was anticipating lower revenues and earnings per share in 1998 than had previously been forecast. The next day, the price of Dura stock dropped 47 percent. The announcement did not mention Albuterol Spiros. In November 1998, Dura announced that the FDA had decided not to approve Albuterol Spiros, "due to electro-mechanical reliability issues and chemistry, manufacturing, and control concerns." The complaint did not allege any decline in Dura's stock price after the November 1998 disclosure.

In reversing a district court opinion that dismissed the Albuterol Spiros allegations for failure to adequately plead loss causation, the Ninth Circuit adopted a notice pleading standard for loss causation. The Ninth Circuit held that loss causation is satisfied where "the plaintiff shows that the misrepresentation touches upon the reasons for the investment's decline in value." 339 F.3d at 938. While the court also stated that "loss causation . . . merely requires pleading that the price at the time of purchase was overstated and sufficient identification of cause," that requirement is not inconsistent with notice pleading, which would not require a discussion of the specific disclosures that materially impacted the stock price. *Id.* This is the appropriate pleading standard and, as a result, the decision of the Ninth Circuit should be affirmed.

Allegations regarding loss causation have been determined by the lower courts to be subject to the liberal pleading requirements of Rule 8 of the Federal Rules of Civil Procedure. *See, e.g., Gebhardt,* 335 F.3d at 830 n.3 (the PSLRA does not change the traditional pleading

rules for materiality and loss causation).[11] Under Rule 8(a)(2), a complaint must include only "a short and plain statement of the claim showing that the pleader is entitled to relief." Such a statement need only "give the defendant fair notice of what the plaintiff's claim is and the grounds upon which it rests." *Conley v. Gibson,* 355 U.S. 41, 47 (1957). Other portions of Rule 8 reinforce this notice pleading standard. Rule 8(e)(1) states that "[n]o technical forms of pleading or motions are required," and Rule 8(f) provides that "[a]ll pleadings shall be so construed as to do substantial justice." Thus, "[a] court may dismiss a complaint only if it is clear that no relief could be granted under any set of facts that could be proved consistent with the allegations." *Hishon v. King & Spalding,* 467 U.S. 69, 73 (1984).

Under this liberal pleading standard, and the standard for loss causation proposed by the Public Pension Funds above (*see supra* Section I.C), a plaintiff should be required merely to allege a "short and plain statement" that there is some potential linkage between a company's disclosures related to the fraud and the expectations of reduced performance (and hence share price) on the part of the securities at issue. Such a statement is not materially different from the standard adopted by the Ninth Circuit in *Broudo,* since neither standard requires a plaintiff to state with any detail the specific factual statements made by a defendant that are related to the fraud.

This Court should not adopt a more stringent standard for pleading loss causation. Requiring a plaintiff to identify, with particularity, each statement made by a defendant that had the effect, for cash flow purposes, of revealing some aspect of the fraud is a complex, information-inten-

[11] Petitioner has not argued, or even suggested, that a heightened pleading standard is required for loss causation.

sive process that is not appropriate at the pleading stage under Fed. R. Civ. P. 8(a). Such a standard would be inconsistent with notice pleading, would necessitate discovery and extensive expert analysis, and, inevitably, would result in the dismissal of meritorious cases.

The determination of the pleading standard applicable to loss causation requires the Court to balance the legitimate needs of defrauded investors in having access to a legal remedy under the federal securities laws against the needs of business to be protected from meritless litigation. The test proposed by the Public Pension Funds, with notice pleading required for loss causation, adequately strikes that balance. Under Rule 9(b), "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." Fed. R. Civ. P. 9(b). Further, the PSLRA requires that a "complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, [a] complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). The PSLRA further mandates that a complaint "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). Thus, every complaint, in order to survive a motion under Rule 12(b)(6), must identify, with particularity every fraudulent statement, why it is false, and must set forth facts that strongly infer that the false statements were made recklessly or with knowledge of their falsity. A complaint that has met these very high hurdles is not a frivolous pleading and it is not burdensome for defendants to be required to defend an action that avers in detail why they

knowingly or recklessly made fraudulent statements that impacted the price of a stock.

Requiring, in pleading loss causation, anything more than a basic averment that the fraud caused the loss, on the other hand, would raise the pleading bar so high that a large number of meritorious claims would be precluded at the pleading stage. As described above, in order to adequately plead loss causation in many complex cases where the corrective statements are not labeled as such, a heightened pleading standard would require an extensive event study analysis to determine which corrective statements impacted expectations of performance and, hence, stock price, and the relationship of those corrective statements to the fraud. In many cases, where defrauders have sought to cover their tracks, it will be impossible without detailed analysis like an event study to plead the particular statements that corrected the fraud and thus "caused" the loss. Accordingly, anything more than a general averment that such corrective statements exist, should not be required.

At the pleading stage, the test advocated by the Ninth Circuit, which does not require any substantive link between corrective disclosures and stock price declines, strikes the correct balance between protecting investors and securities fraud defendants. That decision should be affirmed.

CONCLUSION

For the reasons set forth above, *amici curiae* the Public Pension Funds respectfully request that the Court affirm the judgment of the Ninth Circuit in *Broudo v. Dura Pharmaceuticals, Inc.*

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